Office of Chief Counsel
Internal Revenue Service

memorandum

CC:WR:RMD:SLC:TL-N-1663-99
SMBarnes

date: MAR 03 2000

to: Chief, Examination Division, Rocky Mountain District
Attn: [redacted], International Examiner

from: Assistant District Counsel, Rocky Mountain District, Salt Lake City

subject: [redacted]

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I. Issues to be Addressed.

Initially your request for advice was limited to a debt/equity issue, and indirectly to a section 482 issue, between [redacted] and its parent, [redacted]. However, in subsequent discussion, we have also agreed that we should address a withholding tax issue, a section 163(j) interest deduction issue, and [redacted]'s treatment of its other three U.S. Subsidiaries. The issues are as follows:

1. Whether [redacted] banks, which made loans to [redacted] through their U.S. branches based on [redacted]'s securing such loans with deposits in the [redacted] offices of the

same banks, were mere conduits, and should be disregarded for withholding tax purposes?

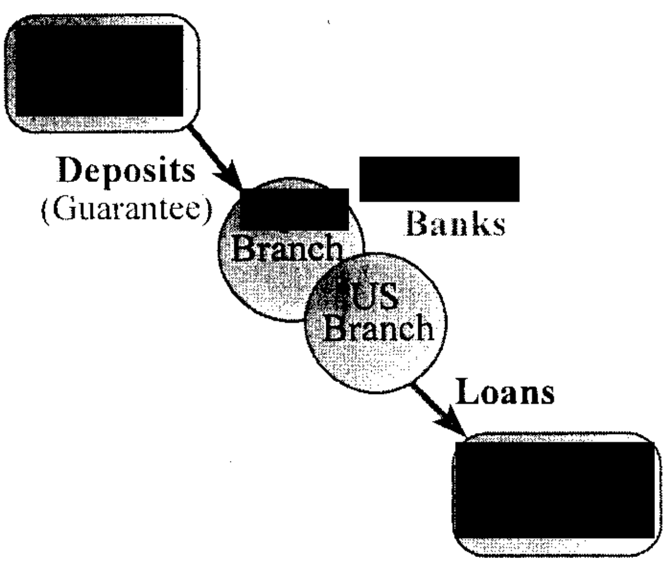
2. Whether "payments" made to [redacted] by the U.S. branches of [redacted] banks, which are secured by deposits of [redacted] ([redacted] Parent) in [redacted] offices of the same banks, are capital contributions rather than bona fide loans?[1]

3. Whether [redacted] is barred from deducting its interest expense, at least in part, pursuant to I.R.C. § 163(j), for the taxable years at issue?

4. If all or part of the loans were determined to be bona fide debt, whether the effective interest rates on the loans exceed fair market interest rates, and should be adjusted pursuant to I.R.C. § 482?

II. Facts.

This case still requires a great deal of factual development. However, the basic scheme that the Examination Division suspects is being employed is as follows:



1. The [redacted] parent, [redacted], deposits funds in the [redacted] Offices of [redacted] banks.

2. The [redacted] Banks, through their U.S. offices, make payments in the form of loans to [redacted].

3. The "loans" are secured by the [redacted] deposits.

4. [redacted] pays interest to the [redacted] banks' U.S. offices.

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[1] If the payments are in fact contributions to capital, [redacted] cannot deduct alleged "interest payments" made to the banks. Rather, the payments would be dividends to [redacted].

5. The [redacted] Banks pay interest to [redacted] on the deposits.

6. [redacted]'s profits are transferred to [redacted] in the form of interest through the banks, acting as intermediaries.

International examiner [redacted] indicated that an International Examiner has contacted her, and stated that he is seeing this same pattern of dealing with regard to [redacted], [redacted]. She also stated that she believes [redacted] is employing this same method of transferring income with [redacted], [redacted]. The following is a list of [redacted] Subsidiaries in the United States. This Information comes from [redacted]

[redacted]

III. *Discussion.*

There are three basic theories that we recommend pursuing in this case. Assuming that the evidence shows that [redacted] guaranteed the loans by placing deposits with the banks, our National Office has recommended that we first allege that the banks were mere conduits, and that [redacted] is liable for withholding tax on interest paid to [redacted].[2] A second legal theory that we should pursue is that the loans are capital contributions, and not debt. If we are able to prove the conduit

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[2]If we can prove that [redacted] guaranteed the loan, but we cannot tie the loans to deposits, we would pursue debt/equity based on the Plantation Patterns, Inc. v. Commissioner, 462 F.2d 712 (5th Cir. 1972), line of cases.

theory, and the debt/equity theory, the effect would be to both disallow [redacted]'s interest deduction, and to hold them liable for withholding tax pursuant to I.R.C. §§ 881 and 1442. Finally, our fall back position should be that the interest expense, for the most part, constitutes "excess interest expense" and should not be allowed pursuant to I.R.C. § 163(j).[3]

A. Withholding Tax

(1) Revenue Ruling 87-89

In discussing fact patterns similar, but not identical to the apparent fact pattern in this case, Rev. Rul. 87-89, 1987 CB 195, clearly states the rule of law that applies when loans to a company are secured by deposits from a related company:

> [I]f the deposit and loan are independent transactions such that the loan from [the bank] would be made or maintained on the same terms irrespective of the deposit, the form of the transaction will be respected for United States income tax purposes. If the loan would not have been made or maintained by [the bank] on the same terms without the corresponding deposit in [the bank] (or a related person of [the bank]) the transaction will be recharacterized as a direct loan because the deposit and loan are dependent transactions used as a device to disguise the substance of the transaction. Gregory v. Helvering, 293 U.S. 465 (1935).

(b)(5)(AC)

[redacted]

[3]I.R.C. § 163(j) merely defers the deduction, rather than eliminates the deduction. This is why we should argue it as a fallback, and not our primary position.

(b)(5)(AC)

[redacted].

(2) Conduit Regulations

Treas. Reg. § 1.881-3 sets forth the rules that allow the Service to disregard the participation of intermediate entities in a financing arrangement, when such entities are acting as conduit entities. Treas. Reg. § 1.881-3(a)(1). The effect of disregarding a conduit entity is that "the financing arrangement is recharacterized as a transaction directly between the remaining parties to the financing arrangement." Treas. Reg. § 1.881-3(a)(3)(ii). Thus, in this case, if the banks were to be disregarded, then the transaction would be one of direct loans from [redacted] to [redacted]. Because [redacted] owns more than [redacted]% of [redacted]'s shares ([redacted] owns [redacted]%), [redacted]'s interest payments on the loans would be payments to [redacted], which are subject to tax pursuant to I.R.C. § 881(a).[5] While section 881(a) speaks of a 30% tax rate, this rate is reduced to 10% pursuant to Art. [redacted] of the U.S./[redacted] Tax Treaty. I.R.C. § 1442 requires [redacted] to withhold the 10% amount and remit it to the Service. [redacted]'s failure to do so results in [redacted] being liable for the 10% tax as well.

Treas. Reg. § 1.881(a)(4)(i) sets forth the test to determine whether an entity qualifies as a conduit entity.

> **(i) In general.** An intermediate entity is a conduit entity with respect to a financing arrangement if--
>
> (A) The participation of the intermediate entity (or entities) in the financing arrangement reduces the tax imposed by section 881 (determined by comparing the aggregate tax imposed under section 881 on payments made on financing transactions making up the financing arrangement with the tax that would have been imposed under paragraph (d) of this section);
>
> (B) The participation of the intermediate entity in the financing arrangement is pursuant to a tax avoidance plan; and
>
> (C) Either--
>
> (1) The intermediate entity is related to the financing entity or the financed entity; or
>
> (2) The intermediate entity would not have participated in the financing arrangement on substantially the same terms but for the fact that the financing entity engaged in the financing transaction with the intermediate entity.

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[5] Because [redacted] owns more than 10% of [redacted]'s shares, the interest cannot be exempt from the tax as portfolio interest. I.R.C. § 881(c)(3)(B).

It appears likely that [redacted] meets all three requirements. (A) The participation of the banks eliminates the 10% tax imposed by section 881(a) as modified by the treaty. (B) In the past, [redacted] made the loans directly to [redacted]. It is probable that the banks were interposed into the arrangement as part of a plan to avoid the withholding tax.[6] (C) (b)(5)(AC) [redacted]. Given [redacted]'s heavy debt load, it appears unlikely that they would be able to obtain such financing without [redacted]'s assistance.[7]

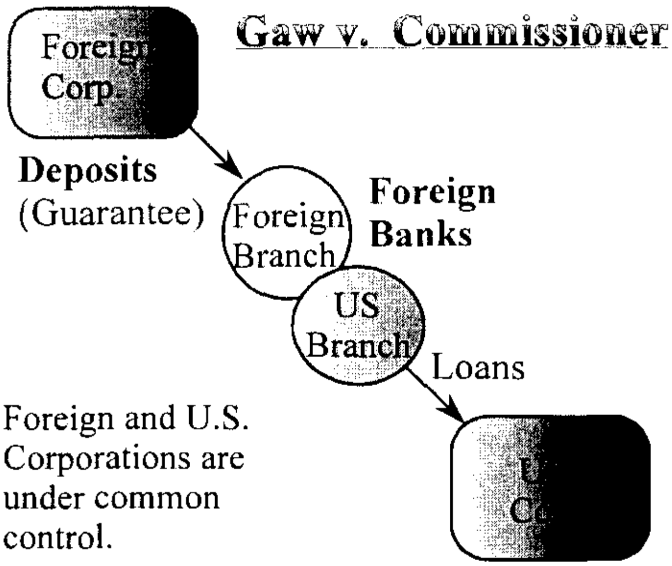
(3) ***Gaw v. Commissioner***

In a case with facts very similar to this case, the Court found that the banks acted as conduits, and held the U.S. entities liable for withholding tax, pursuant to I.R.C. § 1442(a), on the interest payments to the foreign bank's U.S. offices. Like the instant case, the loans were guaranteed by shareholder controlled deposits in the foreign offices of the lending banks.

(b)(5)(AC) [redacted].

Section 3411 of the IRS Restructuring and Reform Act of 1998 adds new I.R.C. § 7525. This provision extends the common law protections of confidentiality which apply to a communication between a taxpayer and an attorney to any federally authorized tax practitioner. In general, the term federally authorized tax practitioner includes attorneys, accountants, enrolled agents and enrolled actuaries. "Tax advice" means advice given with respect to a matter that is within the scope of such individual's authority to practice. The new "tax advice" privilege applies to communications made on or after July 22, 1998, and may be asserted only in noncriminal tax matters. Because the years at issue are pre-1998, this change in the law should not be a factor. However, we will have to coordinate the issue with our National Office, if [redacted] should raise the issue.

[7]See Treas. Reg. § 1.881-(3)(b) for guidance on determining "whether participation of intermediate entit[ies] is pursuant to a tax avoidance plan.



The Tax Court in Gaw v. Commissioner, T.C. Memo. 1995-531, found that the lending banks were merely conduits. Thus, the economic substance of the transactions was payment from the U.S. companies to foreign entities controlled by common shareholders.[8]

In Gaw the shareholders would arrange loans from foreign banks, which were secured by deposits controlled by the shareholders. The deposits would be made to a foreign office of a bank, and in a relatively short period of time, a loan for an equivalent amount would be made to a controlled company in the United States.

The U.S. company would pay interest to the U.S. office of the bank, and the bank would pay interest on the deposits. Generally, the bank would pay 1/2 percent less on the deposits than it received on the loans.[9]

The Court held, based on the "step transaction doctrine," that payments from the U.S. companies were in fact payments made to the foreign entities that received the interest on the deposits. As such, the payments are subject to the 30% tax

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[8]The Court in Gaw v. Commissioner, T.C. Memo. 1995-531 provides a very good, although lengthy, analysis of the "step transaction doctrine." We suggest that you review this section for more detailed information on the "step transaction doctrine."

(b)(5)(AC)

[redacted].

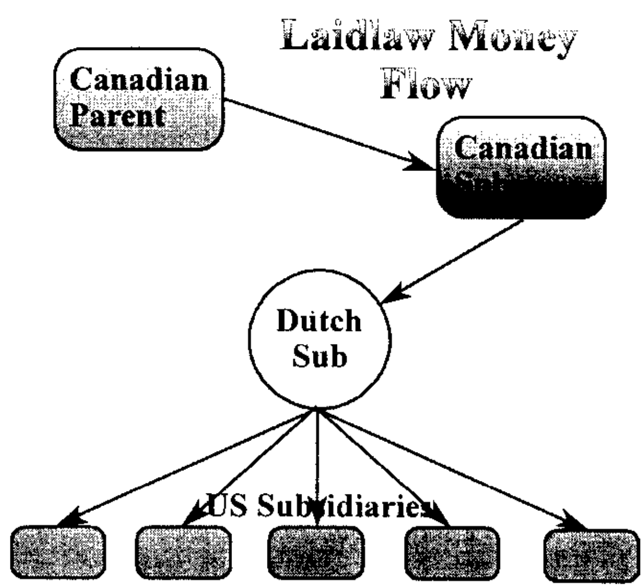
imposed by I.R.C. § 881(a).[10] However, to collect the section 881(a) tax, which is imposed on foreign persons, I.R.C. section 1442(a) requires the U.S. payor of the interest to withhold the 30% tax. Thus, the U.S. payor can be held liable for the tax.

In this case, if the Service is able to show that the banks should be treated as mere conduits, and thus the interest payments, are in substance, payments from [redacted] to [redacted], then [redacted] would be liable under section 1442(a) for its failure to withhold the section 881(a) taxes on its interest payments.

B. Debt Equity

(1) Laidlaw

As you indicated in your request for advice, we should analyze this issue based on the Mixon factors. Estate of Mixon v. United States, 464 F.2d 394, 402 (5^{th} Cir. 1997); The Mixon factors have been further explained in Laidlaw Transportation, Inc. and Subsidiaries v. Commissioner, T.C. Memo. 1998-232.



The Court in Laidlaw applied the Mixon factors to a factual pattern similar to the instant case, and determined that the "loans" were in fact capital contributions. The basic Laidlaw scheme is as follows:

1. The Canadian parent corporation formed two new subsidiaries, a Canadian subsidiary and a Dutch subsidiary.[11]

2. The parent would place money in the Canadian subsidiary, either in the

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[10]Article [redacted] of the U.S.-[redacted] Tax Treaty reduces the rate from 30% to 10% in this case.

[11]Later the sub opened a branch in the Netherlands Antilles to save on Dutch taxes.

form of loans, or capital contributions in exchange for additional shares issued by the subsidiary.

3. The Canadian subsidiary would transfer the funds to the Dutch subsidiary in the form of interest-free loans, and capital contribution (the proportion was based on Dutch tax law requirements).

4. The Dutch subsidiary would transfer the funds in the form of interest bearing loans to the U.S. subsidiaries.

5. The U.S. subsidiaries would claim interest expense deductions on the payments they made back to the Dutch subsidiary.

6. The Dutch subsidiary's only real business was that of transferring funds between various Laidlaw entities.

Regarding this basic scheme, the Tax Court held: "We conclude that for Federal income tax purposes, the advances from [the Dutch subsidiary] to [the U.S. subsidiaries] for which [the U.S. subsidiaries] claim to have paid the interest at issue are equity and not debt." The Laidlaw Court analyzed the following thirteen Mixon factors, plus utilized three other factors that are not particularly relevant to our analysis. In developing the case, it will be important to keep in mind the following thirteen factors:

1. *The Name Given to the Certificates Evidencing the Advances.*

The Court in Laidlaw acknowledged that the labels on the documents used were those normally used in a debt relationship, but also stated, that given the other circumstances in the case, they did not give much weight to this factor. In the [redacted] case, this factor is taken one step further: The debt-related documents are issued by banks. While this factor favors [redacted], like Laidlaw the Service should be able to overcome this factor if other facts indicate that the loans were, in substance, merely the flow-through of [redacted] funds, with the banks acting as conduits, who unlike normal creditors did not expose themselves to any real risk of non-payment.

2. *The Presence or Absence of a fixed Maturity Date.*

[redacted] represents that the "loans" have fixed maturity dates. However, The Examination Division should attempt to obtain documentation on this point. Despite the apparent use of maturity dates, it is important to recognize that historically the principal amounts of the loans have not been repaid, but continuously rolled over. [redacted] claims that interest payments have been timely made, but it is the interest payments that The Examination Division suspects [redacted] is using as a mechanism to transfer income out of its U.S. subsidiaries.[12] The Court in Laidlaw, supra, held that the taxpayer's pattern of revising maturity dates evidenced that the "loans" were really equity. The fact that the banks have been willing to continuously rollover the "loans," most likely because the "loans" are all secured by deposits, indicates that the "loans" in the instant case may really be equity.

3. *The Source of Payments, i.e., Whether the Recipient of Funds Can Repay the Advance With Reasonably Anticipated Cash-Flow or Liquid Assets.*

During the years for which you have records, fiscal [redacted], [redacted] and [redacted], [redacted] Corporation did not have adequate cash flow or liquid assets to repay the notes. [redacted] has been able to pay the interest on the notes each year. While [redacted] did pay down a significant portion of its debt during the [redacted] fiscal year, the pay down did not occur until after International Examiner [redacted] raised the issue with [redacted] during the course of the audit.

We also note that the pay down was accomplished entirely through extraordinary sources of income, and not through "reasonably anticipated cash flow or liquid assets." In part, the funds came from the transfer of funds from [redacted], as part of a rather strange transaction involving the cancellation of shares, and the issuance to [redacted] of $[redacted] in new shares.[13]

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[12] [redacted] may be using this same scheme to bring income back to [redacted] from its subsidiaries in other parts of the world, as well. [redacted]'s financial statements for its worldwide consolidated group, indicate that as a group, it is thinly capitalized. This may be a result of [redacted] loading up its subsidiaries with excessive debt, worldwide.

[13] [redacted]'s [redacted] Financial Statement indicates that [redacted] canceled [redacted] of [redacted] shares of common stock, and then added the $[redacted] dollars to retained earnings ($[redacted]/share). In addition, [redacted] contributed $[redacted] dollars in exchange for [redacted] shares of new stock. In its cover letter to the Financial Statement, [redacted] states: "Generally accepted accounting principles do not allow such a reclassification unless there is a sufficient amount in the

(b)(5)(AC) [redacted].

4. *Whether the Provider of the Funds has the Right to Enforce Payment of Principal and Interest.*

The Taxpayer has stated that the [redacted] bank loans are evidenced by valid promissory notes. However, this has not been verified. (b)(5)(AC) [redacted].

It appears that the banks do have the right to enforce payment of the principal and interest. However, The Examination Division suspects that the understanding between the banks and [redacted] is that the banks are to look to [redacted] as the real guarantee of their repayment. Particularly, since the loans appear to be secured by [redacted]'s deposits with the banks. It will always be much easier for the banks to take the deposits than to attempt collection from a thinly capitalized corporation such as [redacted].

The Court in Laidlaw found that the outward appearance of a legally enforceable obligation to repay was meaningless, if in fact the lender had no real intention of forcing repayment. [redacted] (b)(5)(AC) [redacted]

5. *Whether the Provider of the Advance Gains an Increased Right to Participate in Management.*

[redacted] maintains that the documents evidencing the [redacted] Bank Loans do not give the [redacted] Banks the right to participate in the management of [redacted]. However, The

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common stock account to absorb the entire deficit." [redacted] elected to forego an unqualified report in order to create the appearance that its retained earnings were running less in the red, than GAAP rules require to be shown.

[14]"982 letter" means a letter issued pursuant to I.R.C. § 982.

Examination Division suspects that the banks are mere conduits, and that in substance the "loans" are transfers from [redacted] to [redacted].

[redacted] is [redacted]'s sole shareholder. According to [redacted] management, [redacted] has significant control over the management of [redacted]. Because [redacted] already controls [redacted], this factor is not particularly relevant. There does not appear to be any additional control that [redacted] could gain. (b)(5)(AC) [redacted].

6. ***The Status of the Contribution in Relation to Regular-Creditors.***

In form, the [redacted] Bank Loans appear to be equal to [redacted]'s other obligations. We do not currently have any information to indicate that the [redacted] Bank Loans are subordinate to any other debt of [redacted]. However, the [redacted] bank loans are guaranteed by [redacted].

While you have not yet obtained information concerning the terms of [redacted]'s guarantees, if the banks primarily look to [redacted] to insure repayment of the loans, the effect may be the same as subordination of the bank loan debt. If other creditors understand that [redacted] has assumed primary responsibility for the bank loans, other creditors may be more likely to lend to [redacted]. Especially if they understand that the banks can collect against the loans simply by offsetting [redacted]'s deposits, without ever laying claim to any [redacted] assets.[15] (b)(5)(AC) [redacted].

The Court in Laidlaw held that "[f]ailure to demand timely repayment effectively subordinates intercompany debt to the rights of other creditors who receive payment in the interim." The practice in the instant case was to continuously rollover the [redacted] bank debt. It may well be that other creditors would lend to [redacted] based on their understanding that [redacted] in fact

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(b)(5)(AC) [redacted].

had the ability to rollover the [redacted] Bank debt, and thus would not be required to pay back both the [redacted] bank debt, and the debt to other creditors at the same time. If this is the case, the [redacted] bank debt has effectively been subordinated to other creditors.[16]

7. ***The intent of the parties.***

Prior to the [redacted] bank loans [redacted] received "loans" directly from its parent, [redacted]. The taxpayer was required to pay withholding on the interest payments to [redacted]. I.R.C. §§ 881(a) and 1442(a). [redacted] claims that it intended the [redacted] bank loans to be debt. However, the intent of the parent and the taxpayer has not been adequately explored. It is difficult to determine the intent of the parties until the loan files are reviewed and the relationship between [redacted], [redacted] and the [redacted] Banks has been analyzed.

The Court in Laidlaw, supra, stated:

> Primary reliance upon subjective indications of intent is simply not an effective way of resolving . . . [the debt versus equity] problem. In a land of hard economic facts, we cannot root important decisions in parties' pious declarations of intent. . . . Thus, to reveal a taxpayer's intent, we must consider not only the pronouncements of the parties, but also the circumstances surrounding the transaction. . . .

T.C. Memo. 1998-232.

(b)(5)(AC) [redacted]

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[16]In [redacted]'s fiscal [redacted] Financial Statement, [redacted] included the following in note 1.

> The Parent also assists the Company with financing by providing certain guarantees and has made a commitment to continue providing such guarantees as are needed to continue the operations of the Company. Accordingly, the accompanying financial statements are not necessarily indicative of the conditions that would exist or the results of operations that would prevail if the Company were operated as an unaffiliated entity.

(b)(5)(AC) [redacted].

(b)(5)(AC) [redacted]?

8. ***Whether the Recipient of the Advances is Adequately Capitalized.***

As more fully demonstrated in the "Thin Capitalization" section below, [redacted] is thinly capitalized. This under capitalization appears to be at the heart of [redacted]'s scheme. [redacted] keeps [redacted] heavily in debt, in order to transfer profits, in the form of interest payments, back to [redacted] in [redacted]. Given our discussions with [redacted], there appears to be reason to believe that [redacted] uses this same scheme with its other three U.S. subsidiaries.

In [redacted], after the taxpayer became aware of this issue, [redacted] took steps to alter their balance sheet, to make it appear that [redacted] is better capitalized.[17] Such after the fact manipulation of the books should be placed into its proper perspective. You could argue that [redacted]'s capability to contribute $[redacted] to [redacted]'s capital demonstrates [redacted]'s ability to properly capitalize its subsidiaries, and thus its failure to do so in the past is simply part of its scheme to transfer income to [redacted] in the form of interest payments.

(b)(5)(AC) [redacted].

9. ***Identity of interest between creditor and shareholder.***

The [redacted] Banks do not hold any direct interest in [redacted]. [redacted]'s representatives have stated that [redacted] and the [redacted] Banks do not have interlocking boards of

[17] See footnote 4.

directors, officers or management. However, the relationship between [redacted] and the [redacted] Banks has not been verified.

(b)(5)(AC)

[redacted]. In Laidlaw, the Court counted this factor as a neutral factor, after determining that the lending entity, and thus the loans, were controlled by the same individuals that controlled the borrowing entity.

10. *Source of Interest Payments, i.e., Whether the Recipient of the Funds Pays Interest From Earnings.*

[redacted] has paid interest, on a timely basis, out of its earnings and liquid assets. However, there was a substantial increase in short-term borrowing during the fiscal years [redacted], [redacted] and [redacted]. We understand that you are attempting to obtain information to determine whether or not there was any rollover of unpaid interest into the subsequent year's loans.

However, the essence of the scheme in [redacted] appears to be the payment of significant amounts of interest to [redacted], through the banks, as a means of transferring profits to [redacted]. Based on the facts that we have been given, this factor does seem to differ from Laidlaw, since [redacted] purportedly timely paid its "interest" payments. But, the reason for the difference, i.e., the transfer of profits from one related entity to another, does not form the basis for a normal debtor/creditor relationship.

11. *Ability of the Corporation to Obtain Loans from Outside Lending Institutions.*

In form, the [redacted] Banks appear to be outside lending institutions. [redacted] is required to furnish its financial information to the [redacted] Banks on an annual basis. However, based on the fact that the parent is the guarantor on the bank loans, and based on [redacted]'s history of losses, negative retained earnings and inability to repay the principal on the notes, it does not appear it could obtain outside lending without a guarantee from [redacted].

The question is not limited to [redacted]'s ability to obtain outside loans; rather, could [redacted] have obtained outside loans in the same amounts, and on the same terms offered in the guaranteed bank loans.

(b)(5)(AC) [redacted].

One point to consider is that, particularly before the recent banking problems in [redacted], [redacted] lenders would often be able to assume that a parent company would guarantee the debts of its subsidiaries, even without a formal guarantee signed by the parent. In other words, a debt-laden [redacted] may have been able to obtain credit from [redacted] lenders because of its relationship with [redacted], even though a similarly situated company without such a relationship would not have been able to obtain such loans.

(b)(5)(AC) [redacted]?

12. ***The Extent to Which the Recipient Used the Advances to Acquire Capital Assets.***

A corporation's use of cash to acquire capital assets suggest that the advance is equity. [redacted]'s representatives have stated that the funds were used to obtain inventory, which is not normally considered to be a capital asset. However, [redacted] purchases virtually all of its inventory from its parent.

Despite representations that the funds paid for inventory, the resultant inter-company payable has increased yearly. At the end of fiscal year [redacted] the payable balance was $[redacted]. By the end of [redacted], the balance was $[redacted]. While some of these numbers are intriguing, [redacted] has not yet substantiated the use of the bank loan proceeds. We understand that the Examination Division has requested the loan files. Hopefully, an analysis of the requested files will reveal how [redacted] used the funds.

13. ***Whether the Recipient Repaid the Loans on the Due Date.***

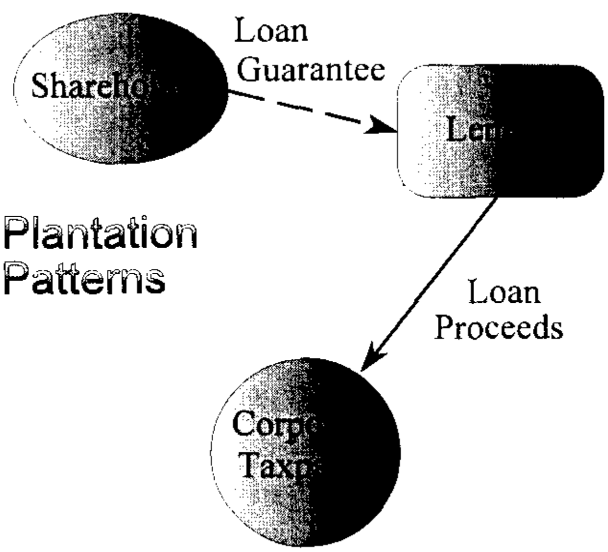
[redacted] claims to have obtained "new loans" and used the proceeds to pay off the expiring [redacted] Bank Loans, on or before their maturity dates. [redacted] argues that the "new loans" are in fact different loans than the original loans, as evidenced by new promissory notes, new maturity dates, and new market interest rates.

However, the taxpayer's yearly refinancing of the loans indicates an inability to repay the loans. Each year, with the exception of [redacted], the taxpayer's debt increased. It was only after the present issues were raised with the taxpayer that the debt amount declined. However, the decline was primarily the result of questionable book manipulation and new cash infusions from the parent.

In Laidlaw the Tax Court found that routinely extending the due date of loans, indicates that the loans are really equity. A similar situation seems to exist in this case. The bottom line is that the taxpayer, despite the re-issuance of new notes, was incapable during the years at issue of paying off the principal balances of the "loans."

(2) Plantation Patterns

In 1972, the Fifth Circuit Court of Appeals affirmed a United States Tax Court decision in Plantation Patterns, Inc. v. Commissioner, 462 F.2d 712 (5^{th} Cir. 1972). The question was whether funds lent to the corporate taxpayer by a third party, but guaranteed by the shareholder, should be counted as debt or equity? The following diagram illustrates the general structure in the Plantations Pattern case:



1. The shareholder of a corporate taxpayer provides a lender with a guarantee.

2. The corporate taxpayer is thinly capitalized.

3. The lender loans money to the corporate taxpayer.

4. The guarantee is significant in the lender's decision to loan the money. In other words, but for the guarantee, the lender would not have lent money to the taxpayer, or at least not on terms as favorable to the taxpayer.

The 11th Circuit explained the holding in Plantation Patterns as follows:

> A transaction structured as a loan by an independent third party to a corporation, and guaranteed by a shareholder, was in substance a loan to the shareholder followed by his contribution of the loan proceeds to the capital of the corporation, and that as a result, the corporation's payments of principal and interest on the debt constituted constructive dividends to the shareholder.

Selfe v. United States, 778 F.2d 769 (11th Cir. 1985).

(a) Thin Capitalization

All of the elements required by Plantation Patterns appear to be present in this case. First, [redacted] appears to meet the "thinly capitalized" requirement of Plantation Patterns. The Court used a balance sheet test, ruling that a corporation is thinly capitalized if "quick assets (cash and accounts receivables) . . . could not cover current liabilities . . ." Given this test, [redacted] was thinly capitalized during the years we have information to make the proper calculation, i.e., fiscal years [redacted], [redacted] and [redacted].

[redacted]

The [redacted] balance sheet shows the following "quick assets" and current liabilities."

Fiscal [redacted] Quick Assets	
Cash and cash equivalents	$ [redacted]
Receivables	[redacted]
Total	**$** [redacted]
Fiscal [redacted] Current Liabilities	
Notes payable to banks	$ [redacted]
Due to parent and affiliates for inventory purchases	[redacted]
Accounts payable and accrued expenses	[redacted]
Capital lease obligations	[redacted]
Total	**$** [redacted]

For fiscal [redacted], current liabilities exceeded "quick assets" by **$** [redacted]. Thus, in accordance with the Plantation Patterns balance sheet test, [redacted] was "thinly capitalized" during fiscal [redacted].

[redacted]

The [redacted] balance sheet shows the following "quick assets" and "current liabilities."

Fiscal [redacted] Quick Assets	
Cash and cash equivalents	$ [redacted]
Receivables	[redacted]
Total	**$** [redacted]
Fiscal [redacted] Current Liabilities	
Notes payable to banks	$ [redacted]
Due to parent and affiliates for inventory purchases	[redacted]
Accounts payable and accrued expenses	[redacted]
Capital lease obligations	[redacted]
Total	**$** [redacted]

For fiscal [redacted], current liabilities exceeded "quick assets" by **$**[redacted]. Thus, in accordance with the <u>Plantation Patterns</u> balance sheet test, [redacted] was "thinly capitalized" during fiscal [redacted].

[redacted]

The [redacted] balance sheet shows the following "quick assets" and "current liabilities."

Fiscal [redacted] Quick Assets	
Cash and cash equivalents	$ [redacted]
Receivables	[redacted]
Total	**$** [redacted]
Fiscal [redacted] Current Liabilities	
Notes payable to banks	$ [redacted]
Due to parent and affiliates for inventory purchases	[redacted]
Accounts payable and accrued expenses	[redacted]
Capital lease obligations	[redacted]
Total	**$** [redacted]

For fiscal [redacted], current liabilities exceeded "quick assets" by $[redacted]. Thus, in accordance with the Plantation Patterns balance sheet test, [redacted] was "thinly capitalized" during fiscal [redacted].

(b) Guaranteed Loans

[redacted] did in fact obtain "loans" from third parties, [redacted] banks. The "loans" were guaranteed by [redacted]'s parent company, [redacted]. During [redacted], it appears that at least four [redacted] banks had outstanding "loans" with [redacted]. These banks were:

[redacted]

These loans were obtained using [redacted]'s guarantee. The importance of [redacted]'s loan guarantees to [redacted]'s ability to obtain financing is set out in Note 1 to [redacted]'s [redacted] Financial Statements. The note reads in part:

> The Parent also assists the Company with financing by providing certain guarantees and has made a commitment to continue providing such guarantees as are needed to continue the operations of the Company. Accordingly, the accompanying financial statements are not necessarily indicative of the conditions that would exist or the results of operations that would prevail if the Company were operated as an unaffiliated entity.

It appears from this statement that the loan guarantees were crucial to [redacted]'s being able to obtain credit. Based on [redacted]'s history of losses, negative retained earnings and inability to repay the principal on the notes, it appears from these facts that the "guarantee was . . . an obligation primary in nature." Plantation Patterns, supra.

Given the facts as they appear at the time of this writing, [redacted] is a thinly capitalized corporation, that relies on its parent, [redacted], for loan guarantees that allow it to borrow significant amounts from the U.S. offices of [redacted] Banks. Thus, it appears that the [redacted] relationship meets all the elements of the Plantation Patterns test. Having met the elements of the test, loans from the [redacted] banks to [redacted] should be deemed to be loans from the banks to [redacted], and capital contributions from [redacted] to [redacted]. Any interest payments on the loans are dividends to [redacted], and not deductible by [redacted].

(3) Debt/Equity Summary and Recommendations.

Given the above debt/equity analysis, the current information suggests a probability that the Service can develop a strong debt/equity issue. However, there is still a great deal of information that the Service will need to gather to fully develop this issue. While this list (which loosely corresponds to the <u>Mixon</u> factors)does not purport to be exhaustive, we suggest that you attempt to obtain the following documents and information, if you have not already done so:[18]

1. (b)(5)(AC) [redacted]

2. (b)(5)(AC) [redacted].

3. (b)(5)(AC) [redacted].

4. (b)(5)(AC) [redacted].

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[18] In all instances we recommend that you request both English and [redacted] versions of documents. You should also insist on full translations of documents, and have translations of important documents verified for accuracy.

5. (b)(5)(AC) [redacted].

6. (b)(5)(AC) [redacted].

7. (b)(5)(AC) [redacted].

8. (b)(5)(AC) [redacted].[19]

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[19]By debt structure, we mean loans from [redacted] banks to [redacted], secured by [redacted] deposits. Prior to this structure, [redacted] was apparently making loans directly to [redacted]. This structure may have been changed based on the advice [redacted]

9. and 10. (b)(5)(AC) [redacted].

11. (b)(5)(AC) [redacted].

12. (b)(5)(AC) [redacted].

13. (b)(5)(AC) [redacted].

C. Section 163(j).

As a fallback position, we recommend that you assert that [redacted]'s interest expense deduction is prohibited (at least in part) by I.R.C. § 163(j). This provision is computational in nature. Its effect is to defer interest deduction for corporations whose debt to equity ratios exceed 1.5 to 1. This appears to be the case with [redacted]. While this approach does offer simplicity, because it is computational, it is only a deferral of the deduction, while the other two theories we have discussed above would result more than timing adjustments.

D. Section 482 Implications.

While a broad reading of I.R.C. § 482 would seem to include adjustments relating to non-bona fide loans, Treas. Reg. § 1.482-2(a)(3) limits the application of section 482 to cases involving bona fide debt. Thus, section 482 could apply in this case in two instances. First, if the loans are determined to be bona fide debt, but the interest rates on the loans are excessive. Second, if the loans are determined to be only partially bona fide debt, and thus the actual interest paid on the bona fide

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of some financial professionals.

debt amount was excessive. For example, if the original principal amount was $100 and $10 was paid annually in interest, but half of the principal was determined to be a contribution to capital, $10 interest on the remaining $50 bona fide principal amount would equal an effective interest rate of 20%. This rate may be excessive, and could be the basis for a section 482 adjustment. Treas. Reg. § 1.482-2(a)(3).

Because the "loans" are made by banks, it is not likely that the interest rates used fall outside of an appropriate range for "arms-length" interest rates. (b)(5)(AC) [redacted].

If you encounter the more likely scenario, where portions of the loans are determined to be bona fide, while other portions are determined to be contributions to capital, you can use section 482 as a basis for your adjustment. It is likely that section 482 will be an alternative basis for the adjustment. Your primary basis for adjustment will probably be that the disallowed portion of the interest is dividend income to the parent.

E. Other Subsidiaries.

Our case will be stronger if we can show a pattern of operation by [redacted]. If all of its subsidiaries are thinly capitalized, and borrow deposit guaranteed loans extensively from [redacted] banks, it is difficult for [redacted] to argue that this is a result of [redacted]'s unique economic circumstances.

(b)(5)(AC) [redacted].

IV. Conclusion

At this point in time, it appears that there are several good issues to be developed in this case. If you are able to develop information to prove the conduit theory, then the Service will be able to hold [redacted] liable for withholding tax pursuant to I.R.C. §§ 881 and 1442. If you are able to develop facts proving the debt/equity theory then the Service will be able to deny [redacted]'s interest deduction. If you are able to successfully develop both theories, the Service will be able hold [redacted] liable for the withholding tax, and also deny the company's interest deductions.

The section 163(j) approach is also available. While we see it as less likely, should the correct facts develop, there is the potential for section 482 interest adjustments. At this point in time, the most important aspect of the Examination Divisions's work is to continue with the factual development of the case.

We have opened a project file on this case, and we are happy to provide continuing assistance upon your request. If you have any questions, please contact me at (801) 799-6623.

S. MARK BARNES
Attorney